CHAPTER 1

Promoting Prosperity in a High-Employment Economy

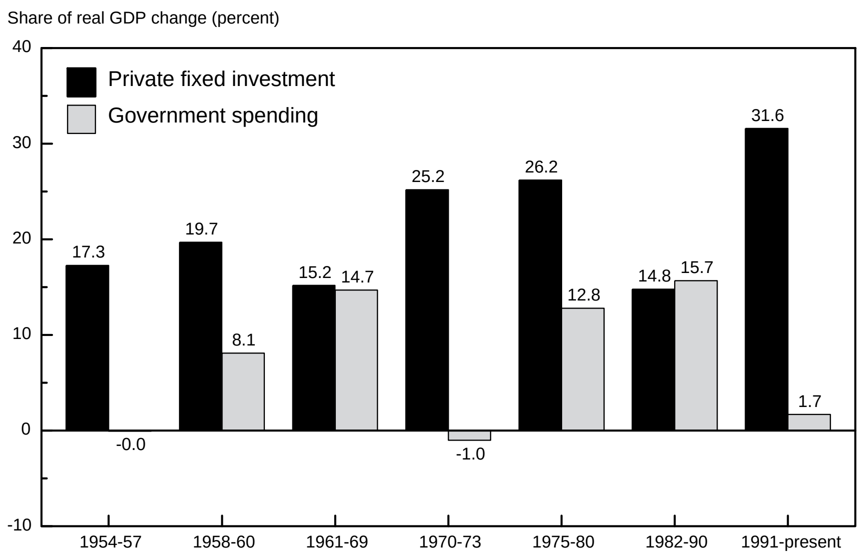
THE PAST YEAR SAW THE NATION'S ECONOMY turn in its best performance in a generation. Over the course of 1997, output growth and job creation remained vigorous while inflation declined. Real (inflation-adjusted) gross domestic product (GDP) grew 3.9 percent, and employment rose by 3.2 million, for an average rate of 267,000 jobs per month. The unemployment rate dropped below 5 percent for the first time in 24 years, yet core inflation (as measured by the consumer price index, excluding its volatile food and energy components) averaged only 2.2 percent, its lowest rate in over 30 years. This exceptional economic performance occurred during a period of historic deficit reduction: the Federal budget deficit, which reached $290 billion in the 1992 fiscal year, declined to only $22 billion in fiscal 1997. And the Administration has submitted a budget for fiscal 1999 that projects a balanced budget for the first time since 1969.

As 1998 begins, the prospects for continued growth with high employment and low inflation remain excellent. The economy is remarkably free of the symptoms that often presage an economic downturn—such as an increase in inflation, an accumulation of inventories, or evidence of financial imbalance. Inflation fell in 1997, and developments in East Asia, by reducing U.S. import prices, are likely to exert additional downward pressure on U.S. inflation in 1998. Economic turmoil in East Asia could affect the global economy, but if international efforts to restore stability there succeed, the main effect on the U.S. economy could simply be to allow continued growth and job creation with a more moderate outlook for interest rates. Another sign that an expansion is nearing its end would be a sudden accumulation of inventories, as businesses find their sales falling short of production. Yet sales were strong in 1997, and inventory-sales ratios are near historical lows. Financial imbalances can also threaten to disrupt an expansion. But today banks and other financial institutions do not appear overextended, as they did in the late 1980s and early 1990s, and the stock market shrugged off a one-day plunge in October (although its continuing high valuation relative to earnings is a source of concern to some). Although the business cycle may not have been vanquished, the economy is in fundamentally sound shape and well-equipped to handle any unexpected bouts of rougher weather.

A principal force behind the current expansion has been private fixed investment. Almost none of the growth in GDP over this expansion has come from increased government spending, whereas close to one-third has come from greater private fixed investment (Chart 1-1). Because of the Administration's deficit reduction efforts, the contribution of government spending to overall growth has been much lower than in most previous postwar expansions (real Federal Government spending has actually declined), while that of private fixed investment has been substantially higher. One benefit of this burst of investment has been a rapid expansion of industrial capacity: over the past 3 years average annual capacity growth has exceeded every previous growth rate since 1968.

Policies such as deficit reduction have contributed to an investment-led recovery and a climate conducive to sustained economic

Chart 1-1 **Investment and Government Spending in Overall GDP Growth**
Real GDP growth during this expansion has been driven by private spending, particularly on fixed investment.



Note: Change in component expressed as fraction of overall change in real GDP.
Sources: Department of Commerce (Bureau of Economic Analysis) and National Bureau of Economic Research.

growth. But the lion's share of the credit for the economy's performance goes to American workers and firms, who have risen to the challenges of a competitive global economy and rapidly changing technology. The role of government in such an economy is not to prop up economic growth with government spending but, more subtly, to provide individuals and businesses with the tools they need to flourish through their own efforts. The range of appropriate government policies in such an economy includes promoting private investment through sound macroeconomic policies, encouraging the formation of skills through training and education, securing opportunity for the marginalized members of our society, and—where necessary—providing assistance to the most vulnerable. Using government to complement, not replace, the market and the private sector has been a fundamental, guiding principle of this Administration's economic strategy from the very beginning. And it is this strategy that has borne fruit over the last 5 years.

Despite the economy's recent exemplary performance, a number of challenges remain. The first is to preserve and nurture the successes achieved so far. And although progress has been made in addressing the longer term problems that have affected the economy since the productivity slowdown of the early 1970s—problems like slow growth in wages and incomes and widening income inequality—more needs to be done. This chapter describes the principles and policies of this Administration for achieving its two basic, overarching goals: securing high and rising living standards now and in the future, and ensuring that the benefits of a higher standard of living are extended to all Americans.

THE ADMINISTRATION'S ECONOMIC STRATEGY

The Employment Act of 1946 (which created the Council of Economic Advisers), together with its later amendments, gave the Federal Government responsibility for stabilizing short-run economic fluctuations, promoting balanced and noninflationary economic growth, and fostering low unemployment. This Administration's strategy in pursuing this mandate has focused on getting the fundamentals right: reducing the budget deficit, investing in technology and the American people, and opening markets at home and abroad. These were the right policies for encouraging the job creation needed to move the economy to full employment, and they are the right policies for attacking the longer term problems of sluggish productivity growth and widening income inequality that began to afflict the economy in the early 1970s.

But there is more to the Administration's policy agenda than can be measured by aggregate economic statistics alone. Getting the fundamentals right means removing the barriers that block people from realizing their potential; it means promoting their sense of individual responsibility and giving them the tools to succeed. Getting the fundamentals right also means fostering a personal commitment by all Americans to help others, a sense of shared responsibility for our Nation's children, and a sense of community in an increasingly multiethnic society.

A CREDIBLE PLAN FOR DEFICIT REDUCTION

The policy course set in 1993 has contributed to the Nation's recent economic health and strength. In 1993 the economy was still recovering from the 1990-91 recession, and it labored under the burden of a Federal budget deficit that had ballooned to $290 billion, an all-time record. The linchpin of the Administration's economic strategy was a credible budget plan that could achieve substantial deficit reduction over the longer term, yet be balanced and gradual enough to allow the economy to gather strength and move toward full employment in the short term. The success of this program rested on achieving an interest rate environment conducive to investment, which would allow the economy to grow in the face of a contractionary fiscal policy. This in turn required that financial markets correctly anticipate an appropriately accommodative monetary policy. In large measure, that is exactly what happened. Long-term interest rates fell to 25-year lows in 1993, spurring a pickup in economic growth.

A key feature of the Administration's deficit reduction plan was its credibility. A credible and realistic program for deficit reduction—one that observers and financial markets judged likely to be fully implemented—was a precondition for the reduction in interest rates that spurred investment-led growth. Fundamental to the plan's credibility was the adoption of a set of economic projections that represented conservative, mainstream forecasts of future growth and inflation. These projections eschewed the "rosy scenarios" of previous budgets, which invariably fell short of reality; they were not meant to indicate the best that the economy could do, but rather how the economy was most likely to perform given past experience. In fact, the economy's performance has been stronger than the Administration projected.

In the 1980s expansive fiscal policy required relatively tight monetary policy in the form of high interest rates to prevent the economy from overheating. This policy mix is particularly unfavorable from the standpoint of fostering longer term growth: high interest rates impede capital formation, while burgeoning government deficits depress national saving and contribute to more borrowing from abroad. The net result of deficit reduction in the 1990s has been to promote a more balanced mix of fiscal and monetary policy. Deficit reduction has also had an important collateral benefit, namely, a restoration of Americans' confidence in the ability of their government to manage its own affairs.

INVESTING IN PEOPLE AND TECHNOLOGY

The primary purpose of deficit reduction, however, is to encourage investment. Hence, this Administration recognized from the outset that a plan that balanced the budget at the expense of the government's own productive investments would ultimately be self-defeating. Far from curtailing public investment, the

Administration has given investment in people and technology a major place in its economic agenda.

Government invests in people by promoting public health and safety, encouraging opportunity and individual responsibility, and assisting in the formation of human capital through education and training. This last function is especially vital in today's high-technology economy, where a skilled work force is an essential condition for future growth. Education is critical if Americans are to capitalize on the opportunities created by new technologies and more open global markets. And education and training programs are of particular importance in the present economic environment as a means of preventing poverty and ensuring opportunity for all. The return to education has risen dramatically since the late 1970s; today, highly skilled workers command a large premium in the labor market over their less skilled counterparts. This rising skill premium is an important reason why earnings inequality is greater today than it was in the late 1970s. Governments have an important role to play in ensuring that all Americans have the opportunity to accumulate the skills necessary for economic success. This requires initiatives to improve public education at the primary and secondary levels, as well as programs to make higher education more accessible. It also requires recognizing that learning must be a lifelong activity in an economy where technological change is ongoing.

Investing in basic research and the development of new technologies is another important function of government. The private sector spends billions of dollars every year on research and development. But economists have long recognized that private sector spending alone in these areas will be less than the optimum. Since the fruits of a new scientific discovery, for example, are enjoyed not merely by the discoverer but by society as a whole, the private incentive for pursuing scientific research falls short of the total social benefit. Moreover, new theories of economic growth place a special emphasis on advances in knowledge through research and development as the motive force behind long-run increases in living standards. This analysis implies that the return to government investment in basic research and technology is likely to be especially high.

OPENING MARKETS AT HOME AND ABROAD

A third major component of the Administration's economic agenda is the promotion of freer and more competitive markets at home and abroad. Domestically, this has involved the pursuit of initiatives directed at enhancing competition—particularly in such industries as telecommunications, electric power, financial services, and health care—and a vigorous approach to antitrust enforcement. It has also meant addressing market failures in such areas as health care and environmental protection. In some cases the effect of these initiatives is a one-time boost to the *level* of output, through greater efficiency and lower costs. But these policies can also sometimes lead to a faster *rate* of economic growth. For example, past experience provides evidence that sensible deregulation can not only help raise efficiency, but also spur continued innovation through greater competition. Moreover, some benefits of these policies are not captured in the GDP statistics at all, but rather take the form of improvements in our quality of life.

The Administration is also committed to reducing the burden of government regulation and ensuring that the benefits of new regulations justify their costs. Many government regulations apply to industries in which technological change is rapidly altering the nature of market competition. A key precept of this Administration's approach to regulation, therefore, is that the regulatory process must be dynamic, with regulatory policies under constant review so as to minimize their burden on consumers and businesses. Another important precept is to refrain from policies that regulate through government fiat in favor of policies that use market-based incentives to attain the desired outcome. Experience with such policies as permit trading for sulfur dioxide emissions suggests that this approach can help ensure that compliance with socially beneficial goals is achieved efficiently and cost-effectively.

This Administration has also worked hard to open markets abroad by encouraging fairer and freer international trade. From his earliest days in office, the President has advocated an outward-looking, internationalist trade policy. During the Administration's first 4 years the United States concluded over 200 trade agreements with other countries. Some of these agreements, such as the North American Free Trade Agreement (NAFTA) and the Uruguay Round agreement of the General Agreement on Tariffs and Trade, were comprehensive in scope, whereas others had much more limited aims—but all are vital to our Nation's competitive future.

Economists generally recognize that an open economy offers both static and dynamic advantages. First, trade benefits an economy by allowing it to specialize in what it does best—a point that economists have made since the early 1800s. Even if a country is more efficient than its neighbors at producing every good it consumes, it can still benefit from trade by specializing in the production of goods in which it is *relatively* more efficient, and then trading its surplus production for whatever else it wants to consume. In addition, a new view of international trade argues that increased trade actually raises an economy's rate of growth, because increased competition and larger markets spur the acquisition of new skills and the development of new technologies. If so, the case for trade liberalization becomes even more compelling, since raising the economy's growth rate—even by a few tenths of a percentage point per year—has vastly more significance for long-run living standards than even a relatively large one-time increase in the level of output.

A RECORD OF ACCOMPLISHMENT

Focusing on the fundamentals in shaping economic policy has paid off by helping to produce an economy that is stronger than it has been in decades. This past year alone saw a drop in the unemployment rate to its lowest level in a generation and the forging of a budget agreement that promises to bring the Federal deficit under control for the first time in decades. Last year also saw significant advances in this Administration's economic agenda along other fronts.

BENEFITS OF A HIGH-EMPLOYMENT ECONOMY

Driven largely by strong growth in business fixed investment, growth in real GDP and employment picked up in the second half of 1993 and persisted in 1994. This robust growth led to a series of monetary policy tightenings over the course of 1994, which resulted in more moderate growth in 1995. In retrospect, 1995 may have been the pause that refreshes. Economic growth exceeded expectations in 1996, and strong growth continued through 1997. The result has been a high-employment economy with the potential to overcome some of the longer term problems of productivity growth and income distribution that built up in the 1970s and 1980s.

A high-employment economy brings enormous economic and social benefits. Essential to personal economic security is the knowledge that work is available to those who seek it, at wages sufficient to keep them and their families out of poverty. A tight labor market increases the confidence of job losers that they will be able to return to work, lures discouraged workers back into the labor force, enhances the prospects of those already at work to get ahead, enables those who want or need to switch jobs to do so without a long period of joblessness, and lowers the duration of a typical unemployment spell. Returning the economy to full employment yields a direct benefit by ensuring that the economy's resources—human and material—are not squandered by needless cyclical unemployment. On average, reducing the unemployment rate by a percentage point raises output by approximately 2 percent; in 1997, 2 percent of GDP was $160 billion, or roughly $600 for every American man, woman, and child. Wasted resources from not producing at potential, together with the human cost of unemployment, are intolerable; the elimination of this waste is the principal benefit of a sustained return to full employment.

But a high-employment economy in which jobs are plentiful and labor markets tight yields other benefits as well. Short-term economic conditions can affect long-term structural unemployment. A tight labor market encourages participation by those who might otherwise be forced to sit on the sidelines, and makes it easier to absorb less skilled or younger and more inexperienced workers into the labor force. These new labor market entrants gain much-needed job experience, building the skills they will need to hold down a job in the future. The importance of this can be seen from the experience of some European countries: prolonged stagnation or recession may have led to a permanent increase in unemployment there, as the unemployed and the never-employed have seen their skills atrophy or become obsolete. Running a high-employment economy, then, may be one of the surest ways to ensure that an unacceptably large fraction of our citizens are not consigned to long-term joblessness and economic marginalization.

From the 1980s until the early 1990s, the economy's ability to reduce poverty through growth alone was hampered by a strong headwind: sustained declines in wages at the low end of the earnings distribution that offset the benefits of an expanding economy for the poorest Americans. As a result, holding a job no longer ensured that a less skilled worker would be able to lift his or her family out of poverty. This adverse secular trend raises even further the stakes of maintaining a high-employment economy.

Keeping the unemployment rate low and job growth high is also necessary if we are to move current welfare recipients into the work force. Early, indirect evidence here is encouraging: employment and labor force participation rates among single women who maintain families—about two-thirds of whom have children under 18—have increased in the past few years. This is probably in part the result of recent welfare reform: the greatest acceleration in employment rates has occurred among those single women most likely to be affected by welfare reform, namely, those with young children. Nevertheless, it is obvious that fostering an economy in which job opportunities are plentiful plays a crucial part in aiding the transition from welfare to work.

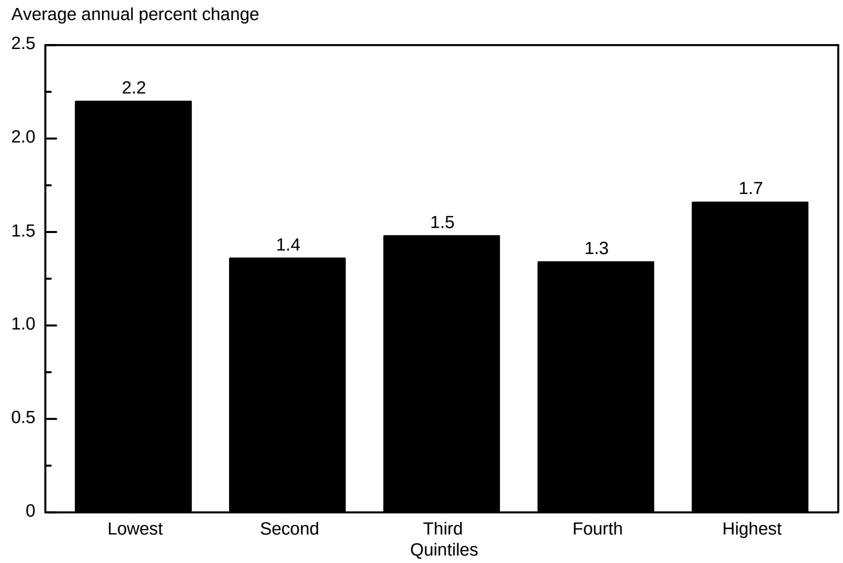
We have begun to see heartening signs that the current expansion is yielding gains in living standards for all Americans, especially those at the bottom of the income distribution. The poverty rate fell to 13.7 percent in 1996, from 15.1 percent in 1993; the poverty rate for black Americans is at a historical low, and in 1997 unemployment among blacks fell to its lowest rate since 1973. Since 1993, household income has grown in each quintile of the income distribution, with the largest percentage increase going to the poorest members of our society (Chart 1-2). Maintaining a full-employment economy is essential if this progress is to continue.

DEFICIT REDUCTION: COMPLETING THE TASK

The most significant economic policy event of 1997 was the passage of a deficit reduction package that will finish the task of balancing the Federal budget by 1999. This will be the first balanced budget since 1969, and only the ninth since World War II (Chart 1-3).

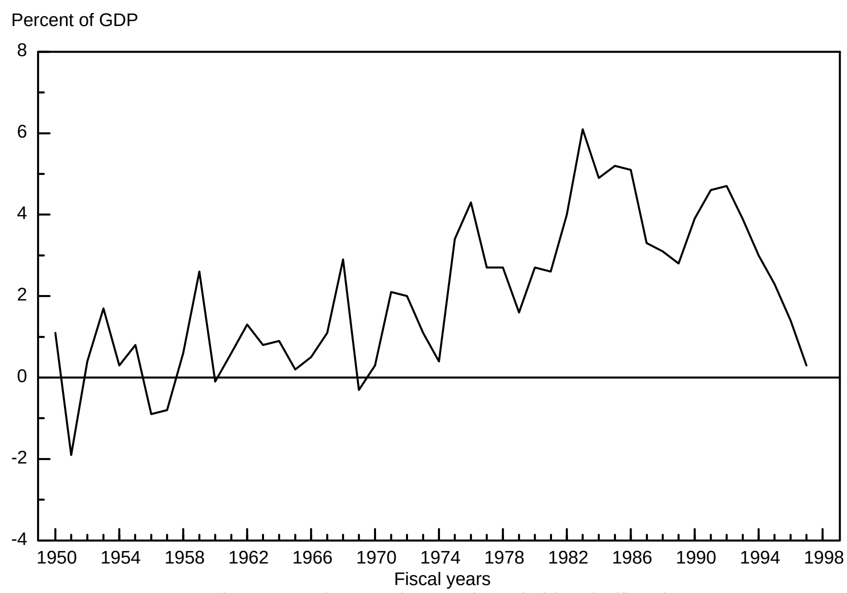
Some have claimed that the expanding economy, not government policy, deserves all the credit for vanquishing the deficit. It is certainly true that ups and downs in the business cycle have an important effect on both revenues and outlays, leading to fluctuations in the deficit. But even when cyclical factors are thus accounted for, it

Chart 1-2 **Real Household Income Growth by Quintile, 1993-96**
From 1993 to 1996, households in the lowest quintile of the income distribution enjoyed the fastest growth in real incomes.



Source: Department of Commerce (Bureau of the Census).

Chart 1-3 **Federal Budget Deficit as a Percent of GDP**
The budget is projected to be in balance in fiscal 1999 for the first time since 1969.



Sources: Department of Commerce (Bureau of Economic Analysis) and Office of Management and Budget.

is evident that policy has played a major role in bringing the deficit under control. It is also worth noting that in January 1993, before the 1993 deficit reduction package was adopted, the Federal deficit was projected to reach $350 billion in fiscal 1998 and to rise to $650 billion in fiscal 2003, even when the economy was projected to be at full employment. Finally, it is difficult to imagine that the economy's performance would have been anywhere near as strong as it has been without a credible and successful attempt to put the government's fiscal house in order. Improvements in economic conditions have played a part in reducing the deficit, but a balanced budget would not now be in sight had the Nation remained on the fiscal course in place in 1992.

Although a balanced budget is often taken as the goal of fiscal policy, from an economic standpoint the motivation for deficit reduction is to raise national saving, thereby augmenting society's future consumption possibilities. When the government's budget is in surplus, in the sense that revenues exceed outlays, the government makes a positive contribution to national saving. As discussed in Chapter 2 of this *Report*, a case for higher national saving can be based on the high return on saving in the United States and the fact that private saving remains low. A higher rate of national saving now would lead to a larger economy when the baby-boom generation retires, thus making it easier to provide for their retirement without imposing undue burdens on younger generations. Although a balanced budget does not add to the government's outstanding debt to the public, which past deficits have ballooned, it does not subtract from it either. Leaving a large public debt in place implies that a sizable portion of existing government resources will continue to be absorbed by interest payments, leaving less for all other spending. Indeed, one legacy of the runup in the national debt that accompanied the deficits of the 1980s and early 1990s has been a sharp increase in the share of total outlays that must be used to make interest payments on the debt (Chart 1-4).

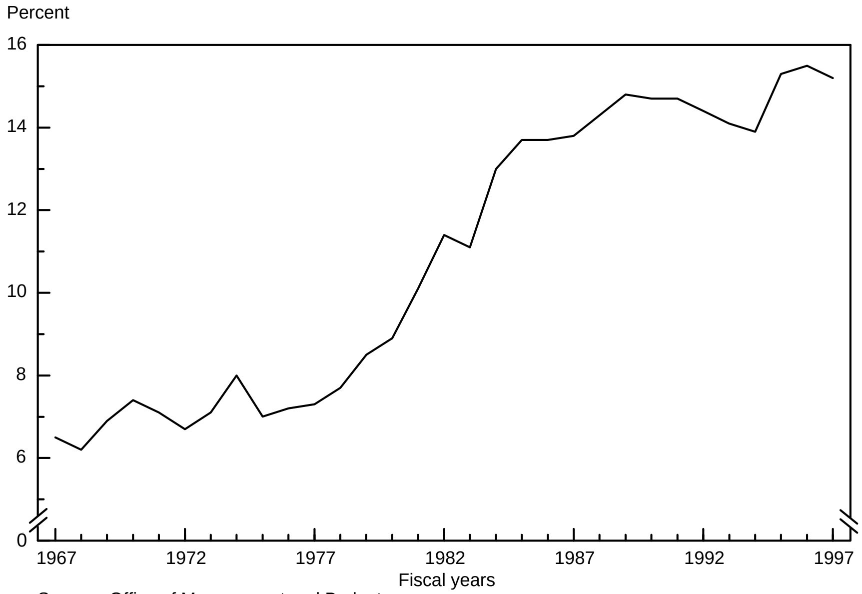
POLICIES TO RAISE GROWTH, REDUCE INEQUALITY, AND INCREASE OPPORTUNITY

A significant part of the Administration's economic agenda also involves investment in people: in a broad sense, this encompasses education and training, measures to promote health, and policies that extend opportunity to all Americans. A number of policies have been put in place to ensure that these investments are made.

Education

The 1997 balanced budget agreement included the largest Federal investment in education in a generation, in the form of initiatives to improve the quality and accessibility of primary, secondary, *and* higher education.

Chart 1-4 **Net Interest as a Share of Federal Outlays**
Net interest payments now represent twice as large a share of total outlays as they did in the 1970s.



Source: Office of Management and Budget.

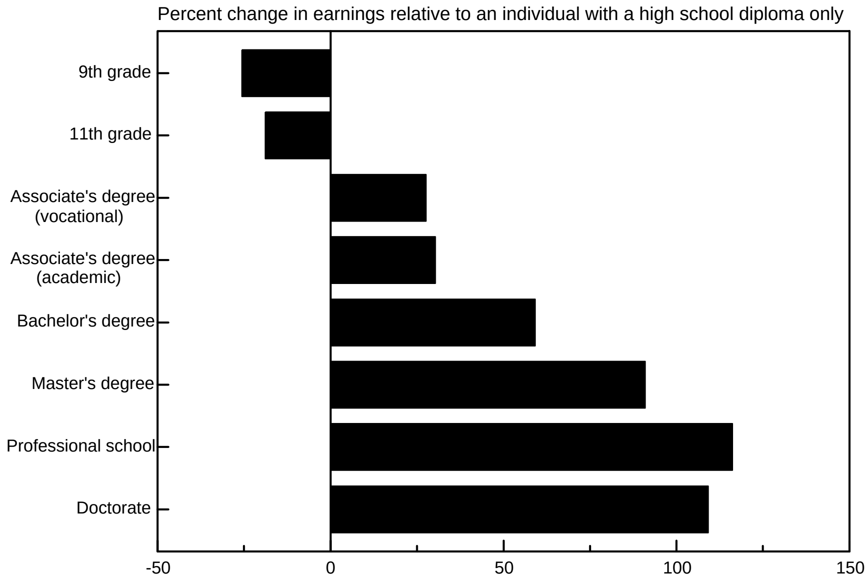
Higher education is a particular priority. The earnings of college graduates have risen sharply relative to those of workers with only a high school education; in today's economy, a college degree has become as vital for success as a high school diploma was a generation ago. Even post-high school education that does not lead to a bachelor's degree (such as an associate's degree program or vocational or technical training) boosts earnings substantially over just completing high school (Chart 1-5).

Moreover, learning must be a lifelong process. A fundamental characteristic of our economy is constant technological change. Such progress holds the promise of higher living standards for all, but it also requires workers to adapt to employers' demands for a well-trained, highly skilled work force. It is therefore critical to provide all individuals—including those not traditionally thought of as "school age"—with access to additional education or training.

The President's higher education initiatives reflect these principles. Specific measures include:

- *The largest Pell grant increase in 20 years*. The balanced budget agreement raises the maximum Pell grant by over 10 percent, to $3,000. Approximately 3.7 million students receive Pell grants, and close to a quarter of a million families will become eligible for the grant for the first time.

Chart 1-5 **Returns to Education**
Earning an associate's degree raises earnings significantly.



Note: 1993 data used in calculations.
Source: Calculations by Council of Economic Advisers, based on the Current Population Survey.

- *HOPE scholarships for post-high school education*. In his 1997 State of the Union address, the President called for making the 13th and 14th years of education as universal as a high school education is today. The HOPE scholarship program accomplishes this by providing a tax credit for higher education expenses of as much as $1,500, enough to cover tuition at a typical community college.

- *A tuition tax credit for Americans of all ages*. A 20-percent tax credit for post-high school tuition expenses will be available for the first $5,000 (and after 2002, $10,000) of qualified education expenses. This tax credit is offered not just to school-age Americans but to those already working as well, to permit workers to upgrade their skills at any time during their life.

- *Tax exemptions for employer-provided education benefits*. The budget agreement extends Section 127 of the tax code for 3 years, allowing workers to exclude up to $5,250 of employer-provided education benefits from their taxable income.

- *A tax deduction for interest on student loans*. Up to $1,000 of interest payments on loans for higher education expenses will be tax-deductible in any given tax year, starting in 1998. This deduction will rise by $500 each year until 2001.

Because public education in the United States is largely administered by local authorities, the Federal Government's ability to influence primary and secondary education is somewhat less direct. Nevertheless, this Administration recognizes that there is much that the Federal Government *can* do to improve our public schools, and has worked to enact programs that will ensure that our children have access to the best possible primary and secondary education. These initiatives include:

- *Establishing national standards*. Research shows that students in countries that have standardized, mandatory examinations do better than students in countries that do not. The Administration's voluntary national testing program has received full funding; this will allow for the development of national fourth-grade reading and eighth-grade mathematics examinations.
- *Expanding Head Start*. The balanced budget agreement raised funding for Head Start by $374 million, to $4.4 billion, to reach the Administration's goal of having 1 million children in the Head Start program by 2002. Since 1993, funding for this program, which has shown great success in preparing low-income preschoolers to enter school, has increased by 57 percent. The program will serve over 830,000 children and their families in 1998, including 40,000 infants and toddlers in the Early Head Start program.
- *Establishing a comprehensive literacy strategy*. Every child should be able to read by the third grade. To meet this basic goal, the President's comprehensive literacy strategy will receive nearly $46 million in new funding in 1998 for State teacher training, family literacy, and tutoring efforts; $210 million was provided in an advance appropriation to be available in 1999, contingent on authorization of a literacy initiative such as the America Reads Challenge.
- *Increasing funding for charter schools*. The President set a goal of having 3,000 locally designed public charter schools in operation by early in the next century. Funding for charter schools is increased by over 50 percent in the balanced budget agreement, to allow the Department of Education to support nearly 1,000 charter schools by the end of 1998.

Health

This Administration has made promoting health, increasing access to health insurance, and improving the functioning of health insurance markets a major priority. The Balanced Budget Act of 1997 allocates $24 billion over 5 years to assist States in providing health insurance for up to 5 million children through Medicaid or State programs. This represents the single largest investment in children's health since Medicaid was begun in 1965. The Administration's 1999 budget proposes to expand access to health insurance further by allowing uninsured Americans between 62 and 65 years old, as well as 55- to 61-year-olds who have been laid off or displaced from their jobs, to buy into the Medicare program. These measures are fully offset so as not to increase the cost of Medicare to the government.

The Balanced Budget Act also takes important steps toward ensuring that Medicare itself remains viable. Structural reforms—such as expanded choice among health care plans and the restructuring of payment systems—will help save $115 billion over 5 years. Recently passed legislation also provides additional funding for preventive care, such as mammograms, which can help keep health care expenses down by catching and treating health problems before they become serious. These and other measures will keep the Medicare trust fund solvent for at least the next decade. The Balanced Budget Act also created a commission to examine long-term solutions to the problems that will face Medicare as a result of the demographic changes coming in the 21st century.

The Administration has also promoted policies to improve the functioning of health insurance markets, increase consumer protection, and improve access to new pharmaceuticals. The Health Insurance Portability and Accountability Act of 1996 helps workers who change jobs by making it easier to carry their health insurance with them to the new job. In 1997 the President's Commission on Consumer Protection and Quality in the Health Care Industry, established to advise the President on changes in the health care system, responded to the President's request to develop and recommend a "Consumer Bill of Rights and Responsibilities." The President urged the Congress to pass appropriate and necessary legislation to ensure that a range of protections are extended to all Americans. And the Food and Drug Administration Modernization Act of 1997, which codifies a number of initiatives taken by this Administration as part of the reinventing government initiative, will help ensure the timely availability of safe and effective new drugs. These policies and others are considered in greater detail in Chapter 5 of this *Report*.

Finally, teenage tobacco use is one of the most important public health concerns that the Nation faces, and it has been rising in recent years. The increase in the tobacco tax passed last year not only will help fund the expansions in children's health insurance coverage described above, but also will help reduce teen smoking. The rise in the tax complements recent Food and Drug Administration rules to limit advertising targeted at youth. Finally, the Administration has indicated its support for national legislation designed to achieve large reductions in teen smoking, with strict financial penalties on the tobacco industry if specific targets in this effort are not met.

Welfare Reform and Poverty Alleviation

Welfare reform presents an ongoing challenge: to ensure that our neediest citizens can maintain a decent standard of living without creating incentives that encourage a life of dependency. This Administration has committed itself to a policy that combines work incentives and community efforts to move people off of welfare and into employment. This has contributed to the largest reduction in welfare rolls in history.

The same long-term changes in the wage structure that give greater rewards to education and skill also imply that some workers will find it difficult to raise themselves and their families out of poverty, even with a full-time job. To make work pay, all those who work must be guaranteed a minimum level of earnings. The Administration has made an expansion of the earned income tax credit (EITC), which raises the take-home pay of eligible low-income workers, a cornerstone of its strategy to promote work and reduce poverty (Box 1-1). This expansion has occurred alongside two increases in the minimum wage (the second

Box 1-1.—Poverty Alleviation, the Earned Income Tax Credit, and the Minimum Wage

A typical cash assistance program guarantees its maximum benefit to those who receive no income, then phases out this benefit as the recipient's income from other sources (usually labor) rises. The disincentive to work that such programs create has been a major concern—perhaps *the* major concern—of policymakers with regard to welfare policy. These disincentives will persist so long as we confine ourselves to considering policies with this structure.

One way to avoid these work disincentive effects is to design programs that add to the wages of low-income workers. One such program, the earned income tax credit, was expanded substantially in 1993. Under the EITC, eligible low-wage workers receive a credit against their income and payroll tax liability; this credit is rebated in cash if the worker's income tax liability is zero. The EITC differs from the typical cash assistance program in that no benefits are paid to those who do not work, and benefits rise as earnings increase (up to some threshold earnings level). It therefore largely eliminates the typical program's work disincentive effects.

The minimum wage complements and enhances the EITC. When used by itself to guarantee a subsistence level of income, the minimum wage must be set very high. But an excessively high minimum wage (that is, substantially above the current one) could discourage hiring. On the other hand, using the EITC alone to guarantee an income floor would require payment of a large subsidy, which would then have to be phased out slowly to minimize the disincentive to earn additional income. This makes the program much more costly. Hence, the minimum wage and the EITC are best employed jointly in designing an optimal assistance package.

of which, in September 1997, raised the minimum wage from $4.75 to $5.15 an hour).

In August 1996 the President signed into law a comprehensive, bipartisan welfare reform bill, which established the Temporary Assistance for Needy Families program. This created a new system of block grants to States and dramatically altered the nature and provision of Federal welfare benefits in America. This legislation has changed the Nation's welfare system into one that requires work in exchange for time-limited assistance and provides support for families moving from welfare to work.

Although these policies have helped shrink the welfare rolls significantly since 1993, much remains to be done. To that end, two additional initiatives have been put in place to advance this Administration's strategy for moving welfare recipients into employment. The first is a tax credit for employers who hire long-term welfare recipients; the credit rebates to employers up to $3,500 in wages paid in the first year and up to $5,000 in the second. The second initiative is the Welfare to Work Job Challenge Fund, which will assist States and communities in moving long-term welfare recipients into lasting, unsubsidized employment. A hallmark of this fund, for which $3 billion has been earmarked, is that it is targeted to those areas of the country most in need of poverty alleviation.

The Child Tax Credit

The Administration proposed a tax cut to help working families with the expense of raising their children. The Taxpayer Relief Act of 1997 will reduce taxes for 26 million families by providing a tax credit of $500 per child. This credit will benefit over 40 million children under age 17, including over 10 million children from working families with incomes below $30,000. Because the credit is partly refundable, large families who have paid significant out-of-pocket payroll taxes can benefit even if they have little or no income tax liability.

STRENGTHENING CITIES AND COMMUNITIES

This Administration has worked to make Federal resources available for investment in our Nation's cities and communities. First, the Administration has sought to expand the number of Empowerment Zones and Enterprise Communities. The initial round of competition, in 1994, led to the establishment of 95 Enterprise Communities and 9 Empowerment Zones; both urban and rural areas were represented. The Taxpayer Relief Act of 1997 established 22 additional Empowerment Zones. To compete for these designations, communities submitted strategic plans for revitalization; this requirement is intended to mobilize local communities and encourage them to harness their talents and resources in framing a plan for local economic development. Designated zones and communities receive tax benefits and flexible grants and are entitled to apply for waivers of certain Federal regulations; the underlying principle of the program is that communities know best how to solve their own problems but may lack the necessary resources.

The Administration has also worked to promote fair access to loans and investment capital for residents of low- and moderate-income areas. Reform of the Community Reinvestment Act regulations required banks to focus on performance—actual lending, investments, and services—rather than paperwork. Since 1993, conventional home mortgage lending to black Americans has increased by 67 percent, lending to Hispanic borrowers is up nearly 50 percent, and lending activity in low- and moderate-income communities has risen by 37 percent. The Administration also obtained $80 million in funding for Community Development Financial Institutions, which make investment capital and other financial products available to low- and moderate-income communities. The President's 1999 budget requests an additional $45 million for this program.

In addition, the President signed into law the "brownfields" program, which will provide tax incentives for the restoration of urban land contaminated by pollution. These incentives will leverage more than $6 billion for nationwide private sector cleanups and the redevelopment of 14,000 contaminated and abandoned sites in economically distressed urban areas.

Several basic principles inform these policies. First, they seek to equip communities with the tools they need in order to flourish—they are helping hands, not handouts. Second, they place the principal responsibility for community development with the communities themselves, because they are closest to their problems. Third, they emphasize private sector engagement rather than government mandates. And finally, they stress results over process: the Enterprise Communities/Empowerment Zones program, for example, gives communities broad scope to determine for themselves the best path for development; similarly, the reformed regulations implementing the Community Reinvestment Act use criteria based on actual outcomes to judge compliance with its provisions.

STRENGTHENING THE PERFORMANCE OF DOMESTIC MARKETS

As part of this Administration's commitment to free and open markets, the Antitrust Division of the Department of Justice has worked together with the Federal Trade Commission to vigorously enforce the Nation's antitrust laws. Recent cases and investigations reveal that the Department of Justice and the Federal Trade Commission have both pursued an aggressive but balanced approach in enforcing antitrust law; in particular, both agencies have sought to ensure the continued growth and competitiveness of high-technology industries.

Chapter 6 of this *Report* describes how the antitrust agencies have worked to attain these goals in several recent cases.

OPENING FOREIGN MARKETS

Progress was also made in 1997 toward opening foreign markets to U.S. goods, as a number of important international trade initiatives were made final. Trade agreements affecting three important sectors were reached, concluding some unfinished business from the Uruguay Round of multilateral negotiations. The first of these agreements, the Information Technology Agreement (ITA), will eliminate tariffs on a large array of information technology products, in which U.S. firms tend to be highly competitive. Also successfully concluded were an agreement covering financial services, which will foster broad liberalization of banking, securities, and insurance markets, and a key agreement to liberalize basic telecommunications services (including telephone services). Chapter 7 of this *Report* considers the Administration's trade policies in more detail.

These negotiations illustrate an important point about trade liberalization. Even though all three agreements involved sectors in which the United States is generally thought to have a competitive advantage, other countries were willing nevertheless to agree to their liberalization. They did so because they recognized that the entry of efficiently produced foreign products in these markets would improve the competitiveness of their own economies: securing goods of the highest quality at the lowest possible price is good for any economy.

PROMOTING AN ECONOMICALLY SOUND ENVIRONMENTAL AGENDA

The Administration took several important steps in 1997 to protect the environment. These included efforts to address global climate change and to improve air quality. In December representatives of the United States and some 160 other countries, meeting in Kyoto, Japan, agreed to establish binding limits on industrial countries' greenhouse gas emissions. These limits are intended to stem the disruptive effects of climate change by stabilizing atmospheric concentrations of greenhouse gases. (Because developing countries will emit an increasing share of global greenhouse gases, the President has indicated that the Kyoto agreement will not be submitted for ratification without meaningful developing-country participation.)

The Administration has proposed several market-based approaches to meeting the Kyoto limits. Domestically, tax incentives for energy-efficient technologies and research and development will spur early efforts to reduce emissions. A national system of tradable permits for greenhouse gas emissions, patterned after the successful permit trading program for sulfur dioxide emissions, will be implemented later under the President's proposal. In addition, the Kyoto agreement allows for trading in greenhouse gas emissions permits on an international scale, as well as opportunities for firms in the industrial countries to receive emissions credits for investing in climate-friendly technologies in developing countries. All of these efforts will help the United States attain its greenhouse gas emissions target in a cost-effective way.

In July 1997 the Environmental Protection Agency (EPA) issued a significantly more stringent standard for ground-level ozone and a new standard for fine particulate matter in the atmosphere. Although the Clean Air Act does not allow for the consideration of costs in setting these standards, under the President's policy the EPA must implement these health-based standards in a cost-effective manner. The Administration's plan for achieving the new air quality standards departs from traditional command-and-control approaches by designing regional strategies that will complement local efforts, and encouraging the development of trading programs for emissions of nitrogen oxides, which are ozone precursors. The nitrogen oxide trading program, like the acid rain program and the trading program envisioned for greenhouse gas emissions, enlists market incentives in controlling pollution and should reduce pollution more cheaply than do traditional regulatory approaches. Chapter 5 of this *Report* provides a detailed assessment of the Administration's environmental policies.

FACING THE CHALLENGES AHEAD

In many ways the U.S. economy today is very different from that in which our parents and grandparents lived and worked. Today, 24 percent of families are headed by a single parent, compared with 14 percent 25 years ago. And three in five married mothers with children under 6 are in the work force—twice as large a share as in 1970. This makes affordable, quality child care a pressing concern for most families. Meanwhile the nature of the labor market has changed significantly: few American workers expect to be working for the same employer—or even to be in the same career—when they retire. Industry has also changed radically: in the 1950s the information technology industry barely existed; today it employs a larger share of the labor force than the automobile industry did in the 1950s and 1960s. And the U.S. population is aging, implying that in the next century there will be fewer workers for every retiree.

This Administration's economic agenda is designed to deal with these changes and the challenges they pose. If the American economy is to maintain its preeminence as the strongest and most dynamic in the world, both policymakers and citizens will have to meet and overcome a number of challenges in the 21st century.

Several such challenges already loom large for this Administration and Congress. Perhaps the most important is preparing for the aging of the population, which requires reforming Medicare and Social Security and promoting retirement security more generally. As reported above, some progress was made in addressing Medicare's immediate problems, but comprehensive reforms are still needed to ensure the program's long-term viability. Likewise, steps will have to be taken to strengthen the finances of the Social Security system.

For almost 60 years Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. A large share of elderly Americans, particularly those with low incomes, rely on Social Security as their primary source of pension income in retirement. The system has enjoyed dramatic success in reducing poverty rates among older Americans. However, many Americans now fear that Social Security will not be there for them when they are ready to retire. This concern reflects the widespread recognition that, under current "intermediate" projections of the Social Security trustees, the system faces a long-term funding gap: beginning in 2012, unless the system is reformed by then, the government will be unable to pay current Social Security benefits in full out of current payroll taxes; it will then have to draw down the system's trust fund, and by 2029 those funds will be exhausted. If still nothing has been done, the government would then face several options which it could adopt singly or in combination: it could reduce benefits until they are in line with collections, raise payroll taxes to cover an unchanged level of benefits, or finance the shortfall from other parts of the budget, by raising other taxes, cutting expenditures on other programs, or borrowing and allowing the budget deficit to increase. One or more of these measures will have to be taken so long as no changes are made to the present system.

Although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. For example, even if nothing is done and the trust fund is exhausted, payroll taxes will still be sufficient to permanently finance roughly 75 percent of benefits. Put another way, the difference between the anticipated income and the anticipated expenditures of the Old Age, Survivors', and Disability Insurance program over the next 75 years amounts to around 2¼ percentage points of taxable payroll, or approximately 1 percent of GDP. (The imbalance is somewhat larger when viewed over a longer horizon.) These facts suggest that the problem of placing Social Security on a sound financial footing can admit of eventual resolution, and the President has proposed a process to devise an appropriate solution over the next 2 years. The President has also proposed that any budget surpluses should be reserved until Social Security reform is achieved.

Medicare reform presents a somewhat thornier problem, in terms of both its complexity and its scale. Unlike Social Security, Medicare promises not just the payment of a sum of money but the delivery of a service: health insurance. The government has little influence over the rate of increase in the cost of providing this service, which has been rising faster than general inflation for decades, largely driven by technological advances in medical care. Higher costs for medical care are projected to account for the bulk of the increase in Medicare expenditures for the next 25 years or so, after which the aging of the baby-boom generation will act to raise expenditures still further through increases in program enrollment. Hence, any long-term reform will have to involve slowing both the rise in health care prices and the growth in volume and intensity of use of covered services. Neither will be accomplished easily.

Before last year's budget legislation was enacted, the trust fund for the component of Medicare that covers hospital costs was projected to fall to zero in 2001. The 1997 reforms will delay the trust fund's depletion until 2010. The legislation also calls for the establishment of a bipartisan commission to assess and recommend the structural changes that will be needed to ensure Medicare's long-term viability.

A second major policy challenge involves continuing the drive for more open international markets. Preferential trade agreements are being negotiated among countries around the world at a rapid pace, and the United States could easily be left behind through inaction. Since 1992, countries in Latin America and Asia have negotiated 20 preferential trade arrangements that exclude the United States. One of these is MERCOSUR, a customs union among four South American countries. The European Union has begun a process intended to culminate in a free trade agreement with Brazil, Argentina, and the other MERCOSUR nations; the President of one European nation has even gone so far as to declare that the economic interests of Latin America lie with Europe, not the United States. Meanwhile the MERCOSUR nations are attempting to extend their preferential trade arrangement to the entire continent. It is clear that now, more than ever, continued engagement with the world trading system will require an active effort on the part of the United States.

In 1997 the Senate voted to move forward on extending the President's so-called fast-track negotiating authority. This authority allows the President to negotiate trade agreements and submit them to the Congress for a yes-or-no vote, without amendments. However, in the House of Representatives the vote to renew fast-track was postponed. Some have voiced concern that free trade hurts American workers and contributes to the U.S. trade deficit. As discussed in Chapter 7, however, market-opening initiatives do not cause net job losses to the U.S. economy as a whole, although they do result in a reallocation of jobs into expanding, export-oriented industries. As the chapter documents, the jobs created by increased trade are good jobs, offering high pay. But some workers are indeed hurt by more open markets, just as some workers are harmed by technological innovation, even though market-opening initiatives unambiguously benefit the economy as a whole.

This Administration has realized from the beginning that the government can minimize the impact of dislocations affecting workers who lose their jobs, by speeding the adjustment process. For example, one of the key provisions of NAFTA involved monitoring those industries that were in danger of being adversely affected by the agreement, and the Administration committed itself early on to providing for dislocated workers through retraining programs. The President's 1999 budget includes proposals to expand the scope of trade adjustment assistance and to increase funding for these programs. More generally, the Administration's commitment to investing in people through education and training serves as a strong complement to its policy of trade liberalization.

A widespread misconception is that one of the benefits of increased trade comes in the form of an improved balance of trade. Economic policies do indeed affect the current account (the broad measure of U.S. international transactions that includes investment income and transfers as well as trade in goods and services), but it is budget, saving, and investment policies, not trade liberalization policies, that do so. The Nation's current account deficit equals its borrowing abroad to finance any excess of investment over domestic saving. The current account is therefore a macroeconomic phenomenon that mirrors the gap between what we as a Nation invest and what we save. The large Federal budget deficits of the 1980s and early 1990s were a form of negative saving, or dissaving, which reduced the total amount of national saving available to cover the Nation's investment in plant and equipment. In an important sense, the Nation was overconsuming in the 1980s, financing its consumption binge by borrowing from foreigners. The result was a large and persistent current account deficit.

We still have a current account deficit today, but for a very different reason. The near elimination of the budget deficit has left more saving available for investment in plant and equipment by the private sector. National saving has risen. But because of the investment boom during this expansion, the gap between investment and saving has persisted. Once again, this shortfall is made up by borrowing from abroad, and the result is a current account deficit. But there is a big difference between borrowing to invest—as the Nation is doing now—and borrowing to consume, as it did in the 1980s. In fact, running a trade deficit in order to expand the Nation's productive capacity is not new to American history—we did much the same thing in the last century, to build up the Nation's infrastructure, most notably during the railroad construction boom. Ironically, therefore, today's trade deficit reflects the economy's current success in growing more rapidly than our trading partners and investing so much—and *not* our free trade policies.

It is always difficult to explain this macroeconomic perspective on the trade deficit to those who are primarily concerned with the microeconomics of their daily lives. But making the case in favor of trade is particularly important now, because real danger threatens should countries turn their backs on a progressive and integrated world economic order. Besides postponing the renewal of the President's traditional trade-negotiating authority, the Congress chose not to support the sort of financial participation in international institutions that is vital for the sound functioning of the international system. Meanwhile financial crises in East Asia have made U.S. international engagement more important, rather than less. Other emerging-market countries are themselves in danger of reacting to the East Asian crises by turning inward. It is important for their economic well-being, as well as our own, that they continue along the path toward an outward-oriented market system, on which they had until recently been making such astonishing progress. This will require difficult macroeconomic and structural adjustments on their part, including reducing their dependence on foreign borrowing. As a result, these countries will have to reduce their trade deficits, and in some cases even turn them into trade surpluses. This will inevitably lead to an increase in U.S. bilateral trade deficits with some East Asian countries. Again, however, such deficits are not the proper gauge of the success or failure of U.S. trade policy.

The Nation faces other, broader challenges in shaping economic policies for the 21st century. First, we must act to help families address the problems they face in today's economy. More American workers today are faced with the need to juggle the demands of the workplace with the demands of family and home. Government must act to ease this burden by ensuring that families have access to quality child care and health care. For this reason the President's 1999 budget includes a $21 billion increase in funding for child care, to make it accessible to more families and raise its quality. An important part of this proposal is increased tax credits for 3 million working families to help them pay for child care, as well as an increase in block grants to States that will directly subsidize child care for low-income families. In addition, the proposal calls for a new Early Learning Fund, along with support for the enforcement of State child care health and safety standards, scholarships for up to 50,000 child care providers per year, and funding for research and consumer education.

We must also continue to invest in our Nation's children. Chapter 3 of this *Report* shows that the last 3 years have witnessed notable improvements in children's well-being along several fronts, including decreases in child poverty, increases in consumption of basic health care services, and improvements in health status and in some measures of educational achievement. However, many children remain economically vulnerable. One in five children in the United States lives in a family whose income is below the poverty line, one in seven does not have access to health insurance, and a large proportion of children fail to achieve basic levels of proficiency in science, mathematics, and reading. Chapter 3 considers ongoing and proposed Administration initiatives that address these problems.

Finally, this country's longstanding goal of achieving equality of opportunity among racial and ethnic groups has not yet been attained. Chapter 4 of this *Report* reviews differences in economic status among blacks, Hispanics, non-Hispanic whites, Asians, and American Indians. Although there has been progress in narrowing these gaps in the postwar period, it has been very uneven, with rapid progress in the 1960s and early 1970s followed by 20 years of stagnation from the early to mid-1970s to the early 1990s. For example, since the mid-1970s the wages of young black college graduates have fallen relative to those of their white counterparts. Although the current expansion has brought signs of renewed progress, substantial disparities in economic status persist. For example, the median wealth of white families is by some estimates 10 times that of black and Hispanic families. More needs to be done to promote equality of opportunity for all Americans. Many of the Administration's current and proposed policies, such as those that encourage community empowerment and education, are intended to address these disparities. And this Administration has pledged itself to furthering a dialogue on race in America.

CONCLUSION

The United States today enjoys some of the most favorable economic conditions in a generation: high growth and low unemployment combined with low and stable inflation. And the success of Americans in adapting to the new economy in which they find themselves has been truly remarkable. But that success—and the economy's present strength—cannot be taken for granted. Recent developments do not herald the end of inflation, the conquest of the business cycle, or the permanent reversal of such secular trends as weak productivity growth and rising income inequality. Rather, there are still long-term changes at work that demand action by individuals, businesses, and governments alike. This Administration has put in place a set of policies that has allowed the economy to grow and to flourish—in particular by putting the Nation's fiscal house in order. But we must continue to pursue sound policies aimed at opening markets at home and abroad, promoting private and public investment, and ensuring that all Americans, regardless of age or origin, have the skills they need to prosper in a world of change and opportunity.